THE WALL STREET JOURNAL. ONLINE

December 02, 2005

Rents Rise, Vacancies Drop As Apartments Join the Boom

By Michael Corkery
The real estate boom has been very good to property owners of all types. But apartment landlords have largely missed the party as low interest rates and the prospect of rising home prices turned thousands of would-be renters into buyers.

Vacant apartments often stayed empty until the landlord lowered the rent. "In some cases we were giving away $50 to $100 in [monthly] rent to keep people coming in the door," says Warren Rose, whose family business owns 52,000 apartments in mostly small cities around the country.

Now that is slowly changing. Vacancy rates are dropping and rents are rising in many parts of the country. About 18 months ago, tenants started trickling back into Mr. Rose's apartments in Virginia and then to his units in the Midwest. These days, he has been able to reduce concessions to renters and his occupancy is rising modestly. "It appears that a recovery is happening," says Mr. Rose, chief operating officer of Edward Rose & Sons, based in Farmington Hills, Mich. "But time will tell."

Landlords are pegging their hopes on continued job growth and the end of the single-family housing boom in 2006. But a weak housing market could hurt them yet again if unsold condos flood back onto the market as rentals.

The national apartment vacancy rate dropped in the third quarter to 5.8%, the lowest point since the third quarter in 2002, according to REIS Inc., a New York-based real-estate research firm. Also in the third quarter, average effective rents -- the rents that landlords actually collect compared to what they ask for -- increased 1.2% over the previous quarter to $895, the highest quarterly up tick since early 2001.

Thomas Toomey, chief executive of United Dominion Realty Trust Inc., a large apartment real-estate investment trust, or REIT, says fundamentals are improving at his apartments in the strong markets of Washington and southern California and more recently in softer markets like Seattle and Denver.

For each new renter in 2002, Mr. Toomey spent about $1,000 on discounted rent and bonuses to employees for signing a new tenant. Today, he spends about $350 on each new renter and occupancy in his apartments is near the 95% that landlords crave.

Mr. Toomey expects even more prospective renters because of higher interest rates and rising home prices. He says that last year, 25% to 30% of the people who moved out of his apartments bought homes. In the third quarter this year, that number has decreased to 15%.

One of the few bright spots during the rental downturn was that landlords could sell their buildings to condo-converters at sky-high prices. In the third quarter, apartments being turned into condos sold for an average of $166,000, compared to $99,000 for units in buildings that were sold but remained as rentals, according to Real Capital Analytics, a New York-based real estate research and consulting firm.

Apartment REITs embraced the condo craze. Over the past two years, for example, AvalonBay Communities Inc., a Virginia-based REIT, has sold $750 million of apartments across the country -- about three times as many properties as it bought, mostly to condo converters. The company is putting a lot of the money from sales into developing new high-end rental apartment buildings.

Sales to condo converters have cushioned the stock prices of publicly traded apartment REITs, even as fundamentals have soured. So while apartment REITs fell 6% in 2002, making them the second worst-performing REIT sector, they bounced back more recently, returning 34% last year, ranking them the second best REIT sector, according to the National Association of Real Estate Investment Trusts. So far this year, apartment REITs have returned an average 11%, trumping every REIT sector, except self-storage and specialty REIT stocks.

The problem is condos could turn out to be a curse instead of a blessing for landlords. If condo owners who paid steep prices for apartments can't sell them as condos, they will likely rent them, hoping the income allows them to pay off their loans. If these "shadow rentals" flood certain markets, landlords could be battered yet again.

Nelsy Gomez is a shadow renter in Coral Gables, Florida. When her apartment building was converted to condos in the summer 2004, Ms. Gomez wanted to stay, but was not interested in buying the unit. Instead she stayed on as a renter, leasing one of the units from someone who bought it as a condo.

"She asked for a $100 increase and we agreed to a $50 increase," says Ms. Gomez, a law student. "We met half way."

Deals like this might make landlords shudder. Their worst fear is that condo owners, when facing steeper mortgage payments, could discount rents dramatically just to fill their units. The impact of the shadow rentals will likely be limited to markets where condo conversions are hot, like Southeast Florida and Las Vegas. In the past, as many as 25% of occupied condos are rented out, says Gleb Nechayev, a senior economist at Torto Wheaton Research, an econometric forecasting subsidiary of real-estate company CB Richard Ellis Group Inc. The exact number of shadow units is difficult to quantify. "That's why it's called 'shadow.' We don't know," says Mr. Nechayev.

For now, landlords have a window of opportunity to take advantage of sky-high home prices by offering more affordable rents. The relationship between rents and home prices has been out of synch since 2001, when the job market sank, taking rents with it. At the same time, people flocked to buy single family homes because of historically low interest rates.

The result is that in many cities, it has become cheaper to rent than to buy. In San Francisco, it costs on average 58% less to rent than to own, compared to 33% in 2001, according to an analysis by Torto Wheaton Research. In Washington, D.C., rental costs are 48% lower than owning, compared to 18% in 2001. In cities like Denver, the changes are much smaller -- rental costs are 41% less than owning, compared to 35% in 2001. These home ownership costs are based on a 15% down payment and a 30-year fixed rate mortgage. They do not take into account property taxes or insurance.

Home ownership is on the rise -- 68.8% in the third quarter this year compared with 67.7% in 2000. But apartment landlords could benefit in coming years from "echo-boomers," a fast growing demographic of children of baby boomers in their 20s who are more likely to rent than buy, says Maxwell Drever, chairman of Concierge Asset Management, a California company that invests in apartments. These echo-boomers are going to need affordable housing, he adds.

He recently bought six apartment buildings in Dallas and Houston, which were built in the 1980s and had low occupancy and needed repairs. He plans to renovate the properties to attract middle-income renters who can't afford to buy. Mr. Drever says he is selling the high-end apartments he owns because "we are getting good prices. We are glad to sell."